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## An introduction to the theories of institutional change

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**Abstract.** Institutional change explains the change of institutions considered as rules and expectations that govern human interactions and paths of development in society. This conceptual paper describes, with an historical perspective, the most important definitions of institution and of institutional change and shows some theories that analyze these critical topics in economics to assess similarities and differences. The future challenge of institutional scholars concludes this study.

**Keywords.** Institutions, Institutional theory, Deinstitutionalization.

**JEL.** D02, E02, G20, I20.

### 1. Introduction

Institutional theory is a discipline to explain both individual and organizational actions. A main research field of the institutional theory is the analysis of how institutions change over time. As a matter of fact, institutions can shape the nature of change across different levels and contexts, as well as themselves change in character, behavior and potency over time and space (Dacin *et al.*, 2002; Di Maggio *et al.*, 1991; Milgrom *et al.*, 1990; Williamson, 2000). A debate within this research field is how to conceptualize institutions and institutional change. Literature suggests different definitions of institution that of course affect the perspectives to study and explain institutional change (cf., Kingston & Caballero, 2009; Hodgson, 2006).

Veblen (1899, p.190) argues that institutions are: “prevalent habits of thought with respect to particular relations and particular functions of the individual and of the community”. Hayek (1973) considers institutions based on shared expectations in society, rather than rules.

North (1990, p.3; 2005) states that institutions are: “the rules of the game in a society, or more formally, are the humanly devised constraints that shape human interaction... reduce uncertainty by providing a structure to everyday life”. In this approach, institutions are based on formal rules (such as, laws and constitutions) and informal constraints (such as, conventions and norms). Aoki (2001, 2007) defines institutions as stable and shared systems of beliefs about the expected behavior of the members of a society in various contingencies. Greif (2006, p.30) adopts a broad definition of institution: “a system of rules, beliefs, norms and organizations that together generate a regularity of (social) behavior”. In brief, North (1990) sees institutions as rules, whereas Aoki (2007, p.6) views institutions as “selfsustaining, salient patterns of social interactions” that give rise to “common knowledge among the players regarding a particular equilibrium path of the game”. These scholars suggest different definitions of institution and different approaches that explain institutional change, given by (Figure 1): designed-based, evolutionary theories of institutional change and equilibrium perspective (cf., Kingston & Caballero, 2009).

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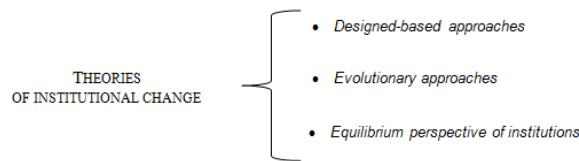


Figure 1. *Theories of institutional change*

## 2. Institutions and theories of institutional change: An historical overview

### 2.1. Designed-based theories of institutional change

In this approach, institutional change is a centralized and collective-choice process in which rules are explicitly specified by a collective political entity, such as the community or the state, and individuals and organizations engage in collective action, conflict and bargaining. Libecap (1989) analyzes the sources of “property rights” rules and considers rule-changing activity as “contracting”: a game governed by a higher level of political rules, and these higher-level rules, together with the activities and perceptions of actors, can shape the direction of institutional change of the lower-level (property rights) rules. Libecap (1989, p.16) argues that exogenous parameter shifts are the prime factor of institutional change. If a parameter shift can lead to a change in the property-rights rules, it depends on the distribution of benefits. Libecap (1989) also claims that institutional change is a “path-dependent” process: the institutions may be a function of current technology, but also of precedent institutions and technologies<sup>1</sup>.

Ostrom (2005) recognizes both exogenous causes of institutional change (e.g., technological change) and endogenous causes (e.g., the depletion of a resource over time). Ostrom (2005) also distinguishes between “operational rules”, which govern day-to-day interactions, “collective choice rules” (rules for choosing operational rules), and “constitutional rules” (rules for choosing collective-choice rules), whereas “meta constitutional rules” are for choosing constitutional rules (e.g., the “rules” by which a civil war is fought). The process of institutional change is that: each individual calculates their expected costs and benefits from an institutional change, and if a “minimum coalition” necessary to effect change agrees to it, an institutional change can occur. A “minimum coalition” is determined by higher-level rule, such as in a democracy, a majority would constitute a winning coalition. Ostrom (2005) argues that if the beneficiaries of institutional change cannot commit to compensate the losers, powerful groups may be able to block beneficial change or impose inefficient change. A further impediment to efficient institutional change is the bounded rationality of players: some or all players may hold incorrect beliefs about the likely effects of a proposed institutional change. Therefore, in these approaches by Libecap (1989) and by Ostrom (2005), an institutional change depends on higher-level rules and on how the decision makers perceive the likely effects of a change in rules. In this research stream, Alston (1996, pp.26-7) outlines that: “Institutional change can be thought of as the result of supply and demand forces in a society. We can think of demanders as constituents and suppliers as the government ... Institutional change results from the bargaining actions of demanders and suppliers.”

However, these theories, based on institutional change as the outcome of a deliberate, collective-choice process of rule-creation, may not explain why formal rules fail to produce their intended outcome.

<sup>11</sup> Coccia, 2005, 2009, 2010, 2010a, 2010b, 2010c, 2014, 2014a, 2014b, 2014c, 2014d, 2015, 2015a, 2017, 2017a, 2018, 2018a, 2018b; Coccia & Benati, 2018; Coccia & Bellitto, 2018; Coccia & Cadario, 2014; Coccia & Rolfo, 2010; Coccia *et al.*, 2015; Benati & Coccia, 2017.

## 2.2. Evolutionary theories of institutional change

Many scholars analyze institutional change as an evolutionary process (Kingston & Caballero, 2009). Theories of evolutionary institutional change suggest that institutional change is due to human actions, such as learning, imitation, etc. The difference between evolutionary and designed-based theories is the role of the selection process determining which rules emerge and adapt in socioeconomic environments. Evolutionary theories do not consider a central mechanism (e.g., legislation) that causes a coordinated shift in the rules perceived by behavior or beliefs of players. New rules or behaviors are due to a decentralized selection process and, as a consequence, successful institutions adapt and grow in society, whereas unsuccessful institutions do not survive. In brief, new rules and patterns of behavior emerge from the uncoordinated choices of many individuals, rather than collective-choice or political processes. Evolutionary theory of institutional change by Veblen (1899) considers the concept of “habits of thought”, where habits are durable and long-run adaptable propensities to think and act in particular ways. Veblen (1899, p.188, *passim*) also argues that: “the evolution of social structure has been a process of natural selection of institutions” – that is, a process of “natural selection of the fittest habits of thought”, both through the “selection of individuals endowed with the fittest temperament”, and through the “adaptation of individual temperament and habits to the changing environment through the formation of new institutions”. Institutional change here is the simultaneous co-evolution of both shared prevalent habits of thought (institutions) and habits of individuals. Therefore, the current habits of thought, both shared and individual, are “received from the past”, affected by the present, and together they jointly affect the future path of institutional change (cf., Brette, 2003).

Hayek (1973) develops an evolutionary theory of institutional change based on selection at the level of social group, where rules of conduct “have evolved because the groups who practiced them were more successful and displaced others (p.18)....thinking and acting are governed by rules which have by a process of selection been evolved in the society” (p. 11). Hayek (1973) claims that group selection generates an overall configuration of rules that evolve towards an optimal configuration based on consistent general principles (the “law of liberty” based on protection of property rights).

Young (1996) argues that historical accidents could lead to the selection of particular conventions, and that in the long run, the pattern of institutional change can follow a “punctuated equilibrium” process in which rapid switches between conventions are interspersed with long periods of stability.

Knight (1995) argues that different sets of rules have different distributional consequences, such that different actors may favor the emergence of different rules. In particular, if some actors have greater bargaining power than others, Knight (1995) claims that this may systematically affect the type of rule that becomes widely-used by the overall society. Levi (1990) stresses that formal rules can give “power” to certain groups, and that disadvantaged groups may force institutional change by “withdrawing their consent” from existing institutional arrangements. This withdrawal of consent could take the form of organized collective action, but it might also occur through the decentralized actions of many individuals.

Overall, then, evolutionary theories and the design-based theories consider exogenous parameter changes as a prime factor of institutional change.

Veblen (1899) argues that changes in population and technology guide institutional change by ensuring that current institutions and habits of thought, inherited from the past, are never ideally suited to the requirements of the present. Hence, institutions and habits are continually evolving: “The evolution of society is substantially a process of mental adaptation on the part of individuals under the stress of circumstances which will no longer tolerate habits of thought formed under and conforming to a different set of circumstances in the past” (Veblen 1899, p.192).

Instead, Ayres (1944, p.187) considers exogenous technological progress as the main driver of institutional change: “technological development forces change upon the institutional structure by changing the material setting in which it operates”. However, Ayres (1944, p.175) also claims that institutions are resistant to change, which can threaten existing patterns of status, wealth and power. In this context, Nelson (2005, p.169) considers changes in physical technology as the main driver of institutional change: “it probably is useful to think of physical and social technologies as coevolving”<sup>2</sup>.

In short, evolutionary theories neglect the role of collective action and political process, while theories which view institutional change as the outcome of a centralized collective-choice process have difficulty explaining changes in informal rules (e.g., social norms) which evolve in a decentralized manner. In fact, North (1990, p.91) provides to informal rules a central role in institutional change. Informal rules are reproduced through an evolutionary process of cultural transmission, and play a key role in institutional change because they change slowly and cannot be changed deliberately. According to North (1990), institutional change is accumulation of many small changes rather than occasional large changes. The process of institutional change is path-dependent because individuals learn, organizations develop, ideologies form in the context of a particular set of formal and informal rules. Organizations can change formal rules to their benefit, and may (indirectly) affect the informal rules. Roland (2004) suggests an analogy between institutional change and tectonic pressure along fault lines (changes in slow-moving institutions) that build up continuously but slowly, but can suddenly provoke an “earthquake” that causes abrupt and substantial changes in fast-moving institutions (i.e., formal rules). Hence, both North (1990) and Roland (2004) assume that changes in informal rules, rather than formal rules, are the main drivers of institutional change.

### 2.3. Theories of the equilibrium view of institutions

The approach of Equilibrium Perspective endeavors to treat formal and informal rules within a unified framework by shifting the focus from the rules governing behavior to the behavior itself (Aoki 2001; Calvert 1995; Greif & Laitin, 2004; Myerson, 2004). In fact, the Equilibrium Perspective of institutions considers the essential role of both formal and informal rules as devices that enable players to coordinate on one of these many equilibria by helping them to achieve a shared set of beliefs about each other’s behavior both on and off the path of play. Calvert (1995, pp.22-23) claims that: “Institution is just a name we give to certain parts of certain kinds of equilibria.” Institutions are identified with these equilibrium patterns of behavior rather than rules that induce the behavior. In the Equilibrium Perspective, institutional change is due to changing expectations, rather than changing rules. Moreover, theories based on institutions as rules consider the enforcement of rules separately from their content; in the Equilibrium Perspective, in contrast, enforcement is endogenous. Exogenous parameter shifts, such as changes in technology or preferences, can disrupt equilibrium, leading individuals and organizations to change the “formal rules” in order to achieve a coordinated shift of many players beliefs about each others’ strategies.

Greif & Laitin (2004) highlight the importance of endogenous institutional change and introduce the term “quasi-parameters”, which are exogenous in the short run, but which gradually change as a result of the play of game, such as the income distribution, or the information available to the players. Hence, changes in quasi-parameters generate institutional change.

<sup>2</sup>cf., Coccia, 2005a, 2015b, 2016, 2017b, 2018e, 2018f.

### 3. Conclusion

Oliver (1992) and Scott (2001) argue that the institutional theory literature has focused on institutional construction and on convergent change processes. However, an equally important research topic is deinstitutionalization: "the processes by which institutions weaken and disappear" (Scott, 2001, p.182). Scott (2001, p.184) states that: "it is useful to place studies of deinstitutionalization in a broader context of institutional change, since the weakening and disappearance of one set of beliefs and practices are likely to be associated with the arrival of new beliefs and practices". Other directions in studies of institutional change are on transnational processes and field-level investigations involving multiple organizations or populations of organizations that cut across industries and societies. The actors here are likely to be collective, ranging from social groups within organizations to various field-level collaborations of organizations.

According to Dacin *et al.*, (2002), a great potential in institutional theory is also to explore the moral dimension of institutions and institutional change (Bellah *et al.*, 1991; Selznick, 1992; Wolfe, 1989). Finally, some scholars have also highlighted the critical interaction between institutions and individual self and character to explain institutional change (cf., Scott, 2001; Bellah *et al.*, 1991). To conclude, the challenge for institutional scholars is to continue to explore and exploit the diversity of viewpoints within the domain of institutional theory as well as outside of its boundaries.



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